OFFICE OF THE
CITY COUNCIL

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DISTRICT TWO

CITY OF SACRAMENTO
CALIFORNIA

March 26, 2008

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D. C. 20551

RE: Docket No. R-1305 - Regulation Z

Dear Ms. Johnson:

The City of Sacramento appreciates the opportunity to comment on the proposed regulations of the Board of Governors of the Federal Reserve System amending Regulation Z, which implements the Truth in Lending Act and the Home Ownership Equity Protection Act (HOEPA). We urge the Board to significantly strengthen its amendments to achieve its stated goal: the protection of consumers from unfair, abusive, or deceptive lending practices prevalent in the subprime mortgage market.

The Board's proposal includes one of the most trenchant analyses of the subprime mortgage crisis that we have read, yet its recommendations fall short of the actions needed to stop the abuses that it recognizes.

The Board consistently falls back on what we can only call an ideological position that eliminating the abusive, unfair and deceptive practices would curtail legitimate subprime lending, raise the cost of home financing, and/or cause liquidity problems in the mortgage market. For over seven years, research conducted by the country's leading universities and housing finance organizations have demonstrated that this is not the case. Particularly compelling is the market research conducted within states that have prohibited predatory practices in subprime lending.* These state initiatives are now the new standard for responsible lending – the new "best practices" that the Board should embrace.

Sacramento has a vested interest in seeing unfair, abusive, and deceptive lending practices prohibited. In 2007, foreclosures in Sacramento County increased six-fold to a rate of one foreclosure for every 67 households – fifth worst in the nation. Notice of Defaults nearly tripled to a level of one notice for every 28 households. The impact of foreclosed homes is particularly severe in our lower income and minority neighborhoods, causing a spiraling decline in property values and related economic activity.

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We urge the Board to consider our recommendations as representing a reasonable level of regulation needed to take subprime mortgage lending back to prudent lending practices. By doing so, the Board will protect higher risk consumers against fraudulent loan practices.

Sincerely,

Sandy Sheedy

Sandy Sheedy, Chair
Law and Legislative Committee

cc: The Honorable Barbara Boxer, United States Senate
The Honorable Dianne Feinstein, United States Senate
The Honorable Doris Matsui, United States Congress
John Freshman, John Freshman Associates

Attachments: Comments of the City of Sacramento on the Federal Reserve Board's Amendments to Regulation Z Concerning Subprime Lending

* An excellent review of state laws on predatory lending, covering almost seven million subprime home loans, is found in Wei Li and Keith S. Ernst, "Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms," in Housing Policy Debate, Vol. 18, No. 2 (2007). The data show that in states regulating deceptive, unfair, and abusive lending practices in the subprime market, "we generally find 1) no significant change in the overall flow of subprime residential mortgage credit, 2) a decrease in the proportion of loans with targeted (predatory) terms, and 3) lower costs to consumers. These findings are important because they suggest that policy makers can address predatory lending in the subprime residential mortgage market without restricting access to credit." The authors are affiliated with the Center for Responsible Lending.

Consumer Protections Should Extend to "Higher-Priced Mortgage Loans" and "Nontraditional" Mortgages, Including those Categorized as "Alt-A" Mortgages.

The unfair, deceptive, and abusive practices in mortgage lending, although found extensively throughout the subprime market, have also reached "nontraditional" loans, including Payment Option ARMs in the alt-A market segment.[1] Therefore, *consumer protections against these reckless lending practices should cover both subprime and nontraditional loans, in recognition of their already higher risk.*

The proposed regulations extend consumer protections only to subprime loans, called "higher priced mortgage loans," defined as a loan secured by the consumer's principal dwelling for which the annual percentage rate (APR) exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate lien loans.

Our difficulty is not with this definition of subprime, but that the Federal Reserve Board's (FRB) primary consumer protections are tied exclusively to it and do not embrace the Payment Option ARMs market, often found under the definitions of "nontraditional" or "alt-A" loans. Option ARM borrowers, facing both rate shock and rising loan balances in the midst of seriously declining home values, contribute to Sacramento's high foreclosure rate. While the proposed regulation hopes that the APR trigger would capture "at least the higher priced end of the alt-A market," which is assumed to be the riskiest, the FRB should follow its own guidance that "the most practical and effective way to protect borrowers is to apply protections based on loan characteristics..." The characteristics of higher priced mortgage loans (i.e, subprime loans) and nontraditional loans, especially Option ARMs, are similar in their layers of risk.

In discussing the loosening of underwriting standards, the FRB warns of the layers of risk in alt-A originations: it starts with nontraditional loans (78 percent of alt-A originations in 2006), but layers risk with partial or no documentation of income (80 percent of alt-A securitized pools in 2006) and loan amounts near the full appraised value of the home. If the object of these regulations is to curb reckless lending practices, then the protections offered to borrowers under these regulations must extend to nontraditional loans, including those made in the alt-A market.

Coverage of Home Loans

We agree with the FRB's proposal that consumer protections should apply to first-lien and subordinate-lien closed-end mortgage loans secured by the borrower's principal dwelling, including home purchase loans, refinancings of

[1] "Nontraditional mortgages" are defined as mortgages that allow the borrower to defer repayment of principal or both principal and interest. "Alt A" borrowers have higher credit scores than subprime borrowers but pose more risk than prime borrowers because of low downpayments, no documentation of income, or other reasons.

loans, and home equity loans. Subordinate liens are excluded from escrow requirements only, not other protections.

Not covering investor-owned property is understandable in light of the regulation's focus on owner-occupancy of principal residences. However, further discussion with state and local officials is warranted to ensure that tenants are protected in the event of foreclosure, particularly in ensuring adequate noticing by the owner and lender/servicer, and whether such protections should be included in the Guidances issued by federal financial regulators.

Ability to Repay: The Need for an Effective Standard

Failure to determine repayment ability undergirded the fraudulent and deceptive lending practices that contributed to the subprime mortgage crisis in America. The FRB's commentary acknowledges that "when borrowers cannot afford to meet their payment obligations, they and their communities suffer significant injury.... If disregard for repayment ability contributes to a rise in delinquencies and foreclosures, as appears to have happened recently, then the credit tightening that may follow can injure all consumers who are potentially in the market for a mortgage loan."

We are therefore baffled why the FRB has not embraced the basic qualification of ability to repay by adopting a standard that defines repayment ability and is enforceable. To the contrary, the proposed regulation explicitly states that "the Board is not proposing to prohibit making an individual loan without regard to repayment ability."[2]

FRB's proposal prohibits a lender from engaging in a pattern or practice of extending credit to a consumer based on the consumer's collateral without regard to repayment ability, including current and expected income, current and expected obligations, employment, and assets other than the collateral. This proposal has two weaknesses:
1) it does not state what constitutes a credible analysis of a borrower's capacity to repay; and 2) it requires the injured party to establish that the lender engaged in a "pattern or practice" of making unaffordable loans.

The FRB's opposition to establishing repayment standards is routed in its claim that they could unduly constrain credit availability. As stated previously, the absence of a requirement for repayment ability – not its presence – has contributed to the constrained credit availability today.

[2] The FRB proposal also states, in the section on using debt-to-income ratios for prepayment penalties: "The Board does not propose to require creditors to use any particular standard for calculating debt or income. A creditor would not violate the prepayment penalty rule if its particular calculation method deviated from those in widely used underwriting handbooks or manuals, so long as the creditor's method was reasonable."

Capacity to repay

Reasonable underwriting standards for repayment ability should include the following:

- underwriting loans based on the fully-indexed rate and fully amortizing payments, and
- establishing a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income (DTI) ratio exceeds 50 percent.

The 50 percent debt-to-income ratio as a repayment standard cannot be considered unduly restrictive in comparison with current data. "In 2007 subprime originations, DTI hit 42.1 percent, up from 41.1 percent in 2006. Borrowers were simply taking on more debt than they could afford." [3]

Despite the FRB proposal's criticism of the use of DTI ratio as too inflexible, the FRB does rely on it in establishing requirements for prepayment fees: "a covered loan may not provide for a prepayment penalty unless the borrower's DTI ratio at consummation does not exceed 50 percent." If a DTI ratio is necessary to prevent the use of a highly risky practice (prepayment penalties) for certain subprime borrowers, then surely it is an appropriate standard for the more basic requirement of repayment ability.

Unenforceability of a "pattern or practice" of making unaffordable loans

The proposed regulations adopt language from the Home Owner Equity and Protection Act (HOEPA) that prohibits a "pattern or practice" of lending based on consumers' collateral without regard to their repayment ability. The difficulty with such a requirement is its unenforceability, as the Board of Governors of the Federal Reserve System and HUD admitted to Congress in 1998: "As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a 'pattern or practice' of making loans without regard to homeowners' income and repayment ability."[4]

The FSB's proposal should require a lender to base the extension of credit to a consumer on the consumer's repayment ability, verifying current and expected income, current and expected obligations, employment, and assets other than the collateral, and to employ the following underwriting standards to evaluate repayment ability:

- *underwriting loans based on the fully-indexed rate and fully amortizing payments, and*

[3] Les Christie, "Subprime Loans Defaulting Even Before Resets...," CNNMoney (February 20, 2008), as quoted in the testimony of Paul Leonard, Center for Responsible Lending, before the California State Senate Banking, Finance and Insurance Committee, March 5, 2008.

[4] Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Act, as quoted in the testimony of Paul Leonard, supra.

- *establishing a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income (DTI) ratio exceeds 50 percent.*

A "pattern and practice" of abuse must be eliminated as the means for enforcement, and the requirement for repayment ability must be extended to nontraditional loans, including Payment Option ARMs in the alt-A market segment.

Prepayment Penalties Should Be Eliminated

In previous responses to the Federal Reserve Board, state and local governments have recommended banning prepayment penalties for the reasons the FRB states in its proposed regulations, some of which are quoted below:

- "These penalties can prevent borrowers who cannot afford to pay the penalty, either in cash or from home equity, from exiting unaffordable or high-cost loans."
- "The loss of home equity and the payment of interest on the financed penalty amount are particularly concerning if the refinance loan represents a loan 'flipping' abuse."
- "The lack of transparency is particularly troubling when originators have incentives to impose prepayment penalty clauses on consumers without giving them a genuine choice."
- "Originators may seek to impose prepayment penalty clauses on consumers simply to increase their own compensation (through larger commissions or yield spread premiums[5]). This risk appears particularly high in the subprime market, where most loans have had prepayment penalties and borrowers may not have had a realistic opportunity to negotiate for a loan without a penalty." [6] (Explanation in parentheses added.)

In short, prepayment penalties create serious market dysfunctions: they trap borrowers in high cost loans, strip equity, lead to serial loan flipping at a higher cost to the borrower, and provide powerful and perverse incentives for steering borrowers into higher cost loans because the broker gains higher compensation through yield spread premiums. It is no wonder that subprime loans with prepayment penalties are 20 percent more likely to end in foreclosure than those without prepayment penalties.[7]

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[5] A "yield spread premium" is a bonus that lenders pay to brokers for placing a borrower in a loan with a higher interest rate than the rate for which the borrower qualifies. The FRB proposal defines "yield spread premium" as the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender." This dollar amount is paid primarily to the broker.

[6] Prepayment penalties have become a factor in the securitized pools of mortgages and their related yield spread premiums. See Kurt Eggert, "What Prevents Loan Modifications?" Housing Policy Debate, Vol. 18, No. 2 (2007). "The right to collect prepayment penalties from a pool of loans can also be split off from the right to collect the principal or interest payments....A sizable prepayment penalty, common in the subprime world, could sabotage much of the benefit of a modification."

[7] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, " Housing Policy Debate, Vol. 18, No. 2 (2007)

The FRB appears to believe that if prepayment penalties were eliminated, subprime loans would bear higher interest rates. However, because the yield spread premiums garnered by prepayment penalties increase the cost of the loan, the Center for Responsible Lending shows that the interest rate differentials are negligible.[8]

Because of the lack of any beneficial effect on borrowers or the mortgage market, prepayment penalties should be banned. The FRB's willingness to permit them for a five year term, but cause them to expire 60 days prior to a payment reset, will not curb the abuses that it recognizes. As many have noted, including the FRB, subprime borrowers are unlikely to be able to raise their credit scores before the initial reset and/or be unable to refinance in that 60-day time period, making the FRB's new provision meaningless. This is particularly true since lenders have raised their credit and equity standards for new and refinanced mortgages.

Yield Spread Premiums Should be Prohibited

Yield spread premiums reward a mortgage broker for closing loans with a higher interest rate than that for which the borrower qualifies. It is a perverse incentive, creating a conflict of interest between the mortgage broker and borrower. Since yield spread premiums are paid in 85 to 90 percent of brokered mortgages, and brokers originated 72 percent of subprime mortgages in 2006,[9] they contribute to widespread market abuses that a borrower, even the most sophisticated, can hardly maneuver around.

Despite its own assertion that it wishes to "limit the potential for unfairness, deception, and abuse," acknowledging that lenders' payment to brokers in yield spread premiums are not transparent, the FRB proposes a solution limited to disclosure of the payment. It does so recognizing that prior disclosure statements under RESPA have been ineffective, quoting HUD's conclusion that "the current good faith estimate (GFE) does not convey to consumers an adequate understanding of how mortgage brokers are paid."

The FRB proposal states that some borrowers may want to pay higher interest rates for the broker's higher payment rather than pay a broker commission at closing from loan proceeds or other resources. However, FRB's contention that yield spread premiums are justified as a way for consumers to reduce up-front costs by trading them for a higher interest rate is refuted by substantial empirical evidence in research conducted by

Harvard Law School: consumers are not given a choice. "Rather, borrowers are simply told that their loans will have a certain interest rate, and they never

[8] Comments of the Center for Responsible Lending in response to questions raised by the Board of Governors of the Federal Reserve System in their June 14, 2007 hearing on the home equity mortgage market and the Board's authority to address abusive lending practices. Pages 11 – 19. The comments are available at www.responsiblelending.org/pdfs/crl-frb-comment-aug-15-2007.pdf.

[9] Testimony of Paul Leonard, March 5, 2008, cited above.

understand that the interest rate is higher than it needs to be and that the higher interest rate is used to finance a payment to the mortgage broker.[10] Professor Jackson concludes that yield spread premiums are an "abusive form of price discrimination (that) substantially increases the overall costs to borrowers, thereby imposing a hidden tax on home ownership for many Americans."[11]

There is no evidence presented in the FRB's proposal that yield spread premiums benefit subprime, nontraditional, or prime borrowers. On the contrary, the evidence shows that yield spread premiums create perverse incentives for increasing the cost of credit to borrowers who could qualify for less costly loans, thus distorting the mortgage market.

Escrow Accounts Should be Required for Subprime and Nontraditional Loans

Escrow accounts for property taxes and hazard insurance have long been a standard in the mortgage industry. The Sacramento Housing and Redevelopment Agency has always required them in its homeownership lending programs, since they are an honest reflection of the borrower's basic obligations.

Not establishing escrows has become the norm in the subprime market and has distorted it.[12] By creating artificially low monthly payments, lenders not requiring escrow accounts make it easy to deceive consumers about the actual cost of these mortgages as compared to a responsible lender.

Escrows for taxes and insurance should be mandated for subprime and nontraditional lending from the time of loan origination and lasting a minimum of five years. Borrowers should not be able to opt out in one year.

Conclusion

The Federal Reserve Board has the opportunity with these amendments to establish and enforce best practices and fairness standards for higher cost loans. We believe the Board can protect consumers most effectively – without affecting access to and the cost of legitimate subprime lending – by adopting the following rules and extending their protections to both higher cost and nontraditional loans:

- Establishing standards for repayment ability
- Prohibiting prepayment penalty fees
- Banning yield spread premiums
- Requiring escrow accounts for taxes and insurance

With these improvements, the Board can raise the nation's confidence that mortgage lending will return to sound and prudent practices.

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[10] Testimony of Howell E. Jackson, Professor of Law, Harvard University, before the Senate Banking Committee Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield-spread Premiums," January 8, 2002.

[11] Id.

[12] See the Comments of the Center for Responsible Lending, pages 35 – 38, for a thorough discussion, with numerous references.